The Indian Market

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INDIA has now emerged as one of the engines of Global growth& is poised to translate this into giving an improved quality of life to her 1bio. + populace.

With the opening-up of the economy and structural reforms over the past decade or so, there has been an infusion of dynamism into the economy and a change in our collective mind-set. There is thus a growing consciousness of resilience in an economy which, despite a “bad” monsoon and record high international Oil prices, still managed a 7% growth in GDP during 2004-05.

While I am quite sure that the relative statistics are known to all of you, I thought I’d like to recap a few of these:

- Exports Growth of more than 20% in each of the last 3 years;
- Foreign Currency Reserves at $144 bio. & climbing;
- Inflation was 5% last year and eased to 3.01% earlier this year;
- 300 Commercial Banks with approx. 66000 branches;
- Impaired Assets(NPAs) now only 2% of aggregate Bank credit;
- Quadruplication of Forex Daily turnover over ’96-’97 (3 bio);
- NEER depreciation 1.09 % last year;
- Portfolio flows to India was 30.6% of global flows to Emerging Market Economies(EMEs) and dev. Countries;
- IT industry employs 1 mio. People directly and provides employment indirectly to another 2.5 mio.
- Services sector contributes 50% of GDP.

A few more facts:

- The no. of poor people is approx. 10 times the total Australian pop.
- This represents an improvement (26.1% of total Indian pop.);
- Per capita income @$550 is still only 9% of Global average;
- Unemployment varies between 8.87% and 9.11%;

This, then, is India as-she-is today.

Having been given these basic facts, let us try and identify what the key Banking Issues are:

There are essentially two different patterns of Issues:

Direct issues arising out of the Banking Industry itself

And

Indirect issues arising out of changes in the Economy.

Since Banking occupies a significant position in the economy of any country, the two are not that much different but I will try and delineate the two, within the time available.

DIRECT

i) The workforce

Due to the large recruitment drives which were carried out in the '70s and '80s, succeeded by years of negligible or no recruitment, due to the onset of automation/computerisation, there has been a significant ageing of the workforce. While computerisation has reduced the sheer drudgery in the work and in theory should have helped free staff for re-deployment in areas such as development and marketing of new products, this has not been the case because of resistance/reluctance on the part of well-settled staff.

New, private banks have a distinct advantage because they are fully automated from day 1 without any legacy systems/ customs /practices. A recent McKinsey report suggests that these new banks achieve productivity levels of 55% of US banks (as opposed to 10% achieved by older state-owned banks such as mine!). Such a report pre-supposes that US standards are what all of us aspire to…Having said this, the problem of Youth – vs – Experience comes to the fore the day any customer wants clarifications on any transaction !

Older Banks have as a response, expanded their operational envelope and either created subsidiaries (with a mixture of old and new staff) for Insurance, Factoring, Merchant Banking, Custodial Services, etc. or else, created niche branches/centres catering to specific needs such as retail Housing loans or the specialised investment needs of High Net Worth Individuals. Increased automation is the order of the day but not all banks (or their customers) are equally comfortable with the changes which are being brought in without any real time to erase decades of banking practices and absorb or assimilate the new changes.

As all banks adopt similar automation platforms and gradually begin to look alike, the issues which will crop up will be the age-old ones of Friendliness and Courtesy to the customer, maybe modified to include better telephone manners or a friendlier website.

ii) Easing of Controls

This has been, ironically, one of the greatest challenges faced by Older Banks: It was much easier to work in an environment where rates operated within a tightly administered band, where products such as derivatives were completely unknown and where the Exchange Control Manual was 2 fat volumes-thick with specifications on every possible combination of Forex Requests together with their accompanying application formats for Permits etc. Today, most of the authorisation levels rest with the Banks and not with the RBI which has disbanded its former Exchange Control Department and instead set up a Forex Manual Department.

The changes started first with freeing of Deposits' rate and has progressed to relative freedom on types of products to be offered and (especially when compared to an environment such as Australia), offers one of the most flexible banking environments for a customer.

The issue here is related to our earlier one of an ageing workforce – how do we ask an individual who has been following elaborate rules and regulations all his life and expects products well-defined by a Regulator to get used to freedom to do his own thing?

iii) Market changes

Banks have necessarily to try and increase their range of products / solutions, as they have been now permitted greater leeway to increase the depth in the Financial Services area and have to compete with global players to enter areas such as Insurance and Banking and have also been permitted into areas such as derivatives. With increased competition from a larger group of players introducing new concepts and no Regulator / Protector, we are suddenly facing choices /demands for resource allocation, demands for getting pricing right and hence the need for making correct decisions for EFFICIENCY of deployed resources – new concepts in a hitherto state-managed environment. The issue is therefore one of knowledge.

A greater impact has been made by reducing significantly, the SLR and CRR that had to be maintained, thus releasing a flood of liquidity into the Financial Markets. This is one of the factors which has led to a massive upgrading in "new" retail products such as housing loans, education loans, etc.

INDIRECT FACTORS

The major challenges to the country today are:
a) Energy
b) Infrastructure Development
c) Agriculture

Energy

Electricity which is taken for granted in all affluent countries is not readily available in India. The position is exacerbated because of increasing demand from a burgeoning middle class which is upwardly mobile. It does not help either that politicians offer free electricity to farmers as part of their election campaigns.

While India has an installed Generation capacity of 112 GW and is ranked 6^{th} in the world, we also have one of the highest transmission loss levels in the world – around 40%.

Another factor is that approx. 60% of the production is coal-based and only 26% is hydroelectric, with connected issues such as the necessity for import of low-ash coal etc.

Each such constraint creates new avenues for investment – in new generation plants, in modernisation programmes, in revamping distribution systems and in improving consumption monitoring. All these in turn create fresh opportunities for Bankers.

Roads

While productivity & efficiency in various sectors have steadily improved over the years, there has not been a matching improvement in infrastructure such as ports, roads and transportation. Although it may have the 3rd largest road network in the world (approx. 3 mio kilometres) and 48 million vehicles, India spent, on average, only 6% of GDP on Infrastructure development as compared to 20% by China.

This is a matter of some concern and with Govt. initiatives gathering momentum, it is expected that in road/highway construction alone, approx. $40 bio is expected to be spent over the next 10-15 years.

This is expected to be in the form of some sort of Public / Private partnership and whether in the form of BOLT or BOOT arrangements, we look forward to interesting times with Bankers and Consultants jostling for a piece of the action.

Ports

There is a similar perception about ports and to kick-start the improvements needed, rights to operate have been sold to important global players such as Maersk, P&O Nedlloyd etc. and the benefit has been felt immediately with unloading times dropping from days to hours and with a regular income stream in the form of royalties for the Govt.

Issues

There are a few common threads which run through all the examples given:

Funding

The pattern of savings of Indian households tilts towards physical assets – 55% of all domestic savings are invested in land, buildings, cattle and gold. There is a school of thought that this would be better utilised in more productive financial assets but this a matter of opinion and there are deep-rooted cultural traditions which cannot be wished away.

Conservatism rules in the Debt market as well and it is seen that Corporate Bonds, for instance, constitutes only 1% of the aggregate financial assets of the country (as compared to 10% in Thailand and 30% in the US). The basic reason for this is that until very recently, Banks were pre-occupied with maintaining their Cash Reserve Ratio and Statutory Liquid ratios, the latter being restricted to Govt. bonds.
Bonds also suffered from a lack of an active Secondary market nor was there any re-finance window available- which naturally discouraged banks from investing in essentially illiquid paper. The lack of a mandatory Credit Rating requirement would also not have helped.

Ironically, with Basel I and II driving the need for stricter prudential norms (and consequent provisioning) Govt. bonds – with a zero risk weightage and an assured return)- in a declining interest rate regime- have become more attractive, thereby drawing Banks away from corporate bonds. The individual investor seems to either want windfall gains through the equity route or sticks to time-tested and "safe" bank/govt. deposits. Given this pattern, there are very few options available for funding infrastructure outlay:

- FDIs
- State- backed specific , tradable Infrastructure Bonds
- Structured products
- Drawing down Forex reserves – the incremental accretion to the Forex reserves (estimated at around 5 bio. annually) should be utilised, in the opinion of some Economists, towards infrastructure expenditure. There is an extension on this idea – that apart from annual accretions, we could also invest a portion of the "surplus". What this would be is a matter of debate but it may be worth considering after taking into account macro fundamentals – interest rates, unemployment, inflation, multiplier factors etc.

Development of Financial Markets

Developed Financial markets, as we are all aware, canalises the reqd. level of liquidity to Real sectors. Financial markets have to achieve critical mass to be considered Deep or Liquid enough to instil confidence in the minds of a greater no. of investors.

Development of commodity and financial derivatives can help achieve a Price Level Equilibrium and enhance liquidity and depth. In India, steps are being taken for amendments in the Securities Regulation and Exchange Contract Act to include OTC derivatives in the legal definition of what constitutes "Security"(hitherto, Derivative Contracts entered into by Banks were neither fish nor fowl).

With greater availability of securitised assets and a development of a viable, active, Secondary market, many of the issues of risk and ill-liquidity in the longer-term asset-funding sectors would be mitigated.